



Statement of the U.S. Chamber of Commerce

ON: **SARBANES-OXLEY SECTION 404: NEW EVIDENCE ON THE COSTS FOR SMALL BUSINESSES**

TO: **HOUSE SMALL BUSINESS COMMITTEE**

BY: **MICHAEL J. RYAN, JR., EXECUTIVE DIRECTOR AND SENIOR VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE**

DATE: **DECEMBER 12, 2007**

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

Testimony before the House Small Business Committee

“Sarbanes-Oxley Section 404: New Evidence on the Costs for Small Businesses”

Testimony by Michael J. Ryan, Jr.

**Executive Director and Senior Vice President, Center for Capital Markets
Competitiveness, U.S. Chamber of Commerce**

December 12, 2007

Good morning, Chairwoman Velázquez, Ranking Member Chabot, and members of the committee. My name is Michael Ryan and I am Executive Director and Senior Vice President of the U.S. Chamber Center for Capital Markets Competitiveness (the “CCMC”). The U.S. Chamber of Commerce is the world’s largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

Introduction

I’m here today to discuss the impact of Sarbanes-Oxley (“SOX”) Section 404 on small public companies and, on behalf of the U.S. Chamber and our small business members, I would like to thank the chairwoman and the committee for holding this hearing and re-focusing attention on this very important issue.

On June 5 of this year, this committee held a similar hearing concerning the disproportionate and unnecessary burden that immediate application of SOX 404 would have on small companies. Since then, the Committee has asked and received answers from the SEC concerning its cost-benefit analysis in connection with SOX 404 implementation for non-accelerated filers. More recently, the U.S. Chamber, working with others, released the results of a survey conducted to quantify the expected cost to non-accelerated filers of immediate application of SOX 404(a) and the application of SOX 404(b) beginning a year from now, which is the current timeline for these two provisions.

As I begin my testimony, I would like to make five basic points:

First, small businesses are critical to the long-term health and vibrancy of the U.S. economy; they are the source of millions of jobs and the incubator of many of the next generation of innovative products and services.

Second, the U.S. Chamber supports the purposes of the Sarbanes Oxley Act, including the application of the Section 404 internal control provisions to small companies.

Third, while the recent changes to Section 404 implementation are positive steps forward, these changes are complex and will necessarily be more costly to implement during their first year than in future years.

Fourth, almost all regulation disproportionately burdens small businesses and this will undoubtedly be the case with Section 404.

And fifth, a one-year delay of Section 404(a) and/or 404(b) while the kinks are worked out of the new rule and guidance would significantly reduce this disproportionate burden on small public businesses.

Background

On November 8, the U.S. Chamber of Commerce released a study showing that, despite recent reforms, SOX Section 404 disproportionately burdens small businesses.

Unless the SEC or Congress takes action, the current timeline will require non-accelerated filers with a calendar year-end to begin complying with SOX 404(a) in early 2008 and SOX 404(b) in early 2009. While the SEC predicted that non-accelerated filers would not engage their auditors for SOX 404 compliance until the first half of 2008, more than 83% of respondents have already done so with respect to SOX 404(a) and more than 58% have done so with respect to SOX 404(b).

The study also shows that more than half of the companies responding with less than \$75 million in market value will spend more than 3% of net income on SOX 404(a). Sixty three percent anticipate a cost increase in the next year due to compliance with 404(a) and 404(b). Finally, more than 58% of the respondents believe that SOX 404 will not help detect and prevent fraud.

Our study shows why small companies complying for the first time with SOX 404 should not be the guinea pigs for the improved rules adopted by the SEC and the PCAOB. We continue to support strong internal controls and believe that the improved rules, if implemented as intended, will address the challenges companies face in complying with Sarbanes-Oxley.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business – manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Furthermore, the Chamber has substantial membership in all 50 states.

The Chamber has strongly supported many of the reforms in Sarbanes-Oxley, including ensuring that boards are more active, independent, and composed of members with significant financial and other expertise. In particular, we believe that having effective and independent audit committees provides important oversight over the work of internal and external accountants. Effective internal controls are an essential part of good financial governance at all companies.

However, the implementation of Section 404 has led to costs and regulatory burdens far beyond what Congress intended and well in excess of the benefits to shareholders and management. This is amplified among smaller public companies due to economies of scale. Companies feel they are getting less effective advice and support from their external auditors, and auditors are increasingly being second-guessed by their new regulator and the trial bar.

The result is predictable: Companies increasingly feel that the costs of being a public company outweigh the benefits, and an important tool companies have used to access capital is being eroded.

I know access to capital and the capital formation process is of particular interest to this committee. Small business drives much of the economic activity, innovation, and job creation in the United States. Over the last decade, for example, small businesses have generated 60 to 80 percent of net new jobs.¹ These businesses made up 97 percent of exporters and produced 28 percent of the known export value in FY 2005.² Small businesses employ 41 percent of high-tech workers and produce 13 to 14 times more patents per employee than large patenting businesses.³

For well over a century, this has been the greatest country on Earth for entrepreneurs and innovators to access low-cost capital to start and expand a business. Transparent and liquid public markets have been a key part of this. Without these markets, small firms can't get the venture capital or bank loans they need to buy new equipment, hire staff, or develop and market their products. Venture capital firms need a clear way get back their investment at a fair price. This usually means taking a company public. If the costs of becoming a public company are unnecessarily increased, then some companies will not get the venture capital they need, resulting in less innovation and competition within the marketplace. Banks also depend on the capital markets to securitize the loans they make to small companies, which allows for greater lending to small businesses.

Statistical evidence indicates that regulatory changes resulting from implementation of Section 404 of SOX have had a disproportionate impact on the cost of capital for smaller businesses that have already had to comply. For example, a \$1 million to \$2 million compliance price tag is an enormous burden on a company that has \$3 million in net income.⁴ A study released by the GAO in April 2006 stated that public companies with market capitalization of \$75 million or less paid a median of \$1.14 in audit fees for every \$100 in revenues. This compares to \$0.13 in audit fees for public companies with market capitalization greater than \$1 billion.⁵

Fortunately, the costs associated with small business capital formation have come to the forefront of the agenda for financial markets' regulators. The SEC and PCAOB have made a good-faith attempt at providing scalable rules and guidance to smaller companies. The question now is will it be implemented as intended?

Correcting the Implementation of Section 404 of Sarbanes-Oxley

The Chamber has been strongly supportive of most provisions of SOX and believes that SOX has had positive effects in causing boards, management, and external auditors to be more thorough and attentive in fulfilling their responsibilities. Our support for the Sarbanes Oxley Act includes the internal control provisions set forth in Section 404. And, we support the application of Section 404 to non-accelerated filers.

¹ Small Business Administration Web site, <http://app1.sba.gov/faqs/faqindex.cfm?areaID=24>.

² *Id.*

³ *Id.*

⁴ Comment by Clay Corbus, Town Hall Meeting, Commission on the Regulation of U.S. Capital Markets in the 21st Century, San Francisco, October 12, 2006.

⁵ U.S. Government Accountability Office, Report to the Committee on Small Business and Entrepreneurship, *U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, at 17. (April 2006) (GAO Report) available at: <http://www.gao.gov/new.items/d06361.pdf>.

The problem has been, as almost everyone agrees, the failed implementation of Section 404. The 168 words that comprise Section 404, as well as the accompanying Auditing Standard 2 (“AS2”), have created regulation that produces costs far in excess of benefits, particularly for small companies. As Chairman Cox has noted, “Congress never intended that the 404 process should become inflexible, burdensome, and wasteful. The objective of Section 404 is to provide meaningful disclosure to investors about the effectiveness of a company’s internal controls systems, without creating unnecessary compliance burdens or wasting shareholder resources.”

U.S. Chamber members have frequently expressed concern that the implementation of Section 404 has had a negative effect on the competitiveness of U.S. companies and the U.S. capital markets, and created burdens on companies and their management well beyond what Congress intended. While Section 404 was fundamentally conceived as a disclosure requirement to provide more information about internal controls, under AS2 it has evolved into a substantive requirement for specific levels of internal controls that goes far beyond the Congressional mandate.

When the SEC and PCAOB issued proposed revisions in December 2006, the Chamber voiced a number of concerns (see comment letter available at: <http://www.sec.gov/comments/s7-24-06/s72406-213.pdf>). Key recommendations included: ensuring a reasonable cost-benefit balance; performing a cost-benefit analysis after the rules are adopted; aligning SEC management guidance with AS5; clarifying terms such as material weakness, significant deficiency, and materiality; clarifying Auditing Standard 3; aligning Auditing Standard 4 with AS5; ensuring that the rules are both risk-based and scalable; providing more certainty regarding the proposed safe harbor; educating the public about the role and scope of an audit and that a restatement does not necessarily indicate a material weakness; allowing for greater use of the work of others; providing specific guidance on IT systems and controls; and promulgating additional guidance on footnote disclosure controls. The Chamber also raised serious concerns about the extent to which the new standards will improve “on the ground” implementation.

We once again applaud the initiative in May by the Securities and Exchange Commission (“SEC”) and the Public Company Accounting Oversight Board (“PCAOB”) to fix the implementation process of Section 404 to better reflect the intent of Congress and the needs of investors and companies. We view the PCAOB’s new auditing standard as well as the SEC’s guidance for companies as a significant step forward and we commend Chairman Cox and Chairman Olson for their leadership, time, and energy to bring balance to the system. In the end, we are hopeful that these changes will restore the balance we believe Congress had intended all along and will bring the costs more in line with the benefits.

Further, we recognize and strongly support the efforts the SEC and PCAOB have put forth since May to ensure that auditors and public companies alike fully understand the new rule and guidance and implement them in as cost effective manner as possible. These efforts have taken many forms, including hosting town hall meets around the country and issuing detailed guidance. We believe, however, that the need for this effort – and we agree that it was needed – only goes to support our argument for further delay for non-accelerated filers. That is, the changes put in place in May by the SEC and PCAOB are complex, not easily understood and will require a great deal of time and energy to work out the details. Therefore, implementation in 2007 and 2008 will necessarily be more costly than will be the case in future years when the transition pain will be behind us and the results of our survey support this. In the meantime, U.S.

small businesses should not have to serve as guinea pigs in this process and shoulder a disproportionate regulatory burden.

A Delay for Smaller Companies

The Chamber has called for a further delay in compliance with Section 404 for smaller public companies until the new rules and guidance have been fully tested by larger companies. Note that only companies with a market capitalization greater than \$75 million have had to comply with Section 404 to-date. With a further delay for smaller businesses, we will be better able to leverage the experience of larger companies and the auditing profession to ensure that implementation costs are minimized. Failure to do this could significantly undermine the cost-cutting objectives of the new standards. We also need to remain prepared to make additional changes if the new rules don't work as intended.

As it stands today, smaller companies will have to begin complying with the management requirements of Section 404(a) in their annual reports for fiscal years ending on or after December 15, 2007. They will have to comply with Section 404(b) requiring an auditor's attestation report on internal control over financial reporting in their annual reports starting with the first annual report filed for the fiscal year ending on or after December 15, 2008.

Two of the five SEC Commissioners—Commissioner Atkins and Commissioner Casey—have publicly indicated a willingness to reconsider such a delay. The Senate Committee on Small Business and Entrepreneurship led by Chairman Kerry and Ranking Member Snowe held a hearing on April 18, and the Senators have publicly called for a further delay. The Office of Advocacy of the Small Business Administration has also joined in to ask the SEC to revisit the issue of compliance deadlines. And just last week Representative Spencer Bachus, Ranking Member of the House Financial Services Committee, sent a letter to Chairman Cox asking for a one-year delay in the implementation of Section 404(b). We once again urge this Committee to support this call for a reasonable, additional one-year extension for smaller issuers.

Additional Reforms to Enhance Small Business Competitiveness and Job Creation

The Chamber believes that SOX has become a catch-all term to refer to a broader set of issues facing the public markets and smaller public companies in particular. While Section 404 is a significant part of the problem, it is not the only part. U.S. companies are facing changing, retroactively applied accounting rules that are ever-increasing in complexity. As a result, one in 10 public companies was forced to restate its earnings last year. This system is not working for companies, investors, or auditors.

America's securities class action litigation system is broken. It provides inadequate compensation to injured parties without deterring future wrongdoers. It fails to protect small, undiversified investors, who seldom receive more than pennies on the dollar, while attorneys on both sides rake in millions of dollars in fees. Moreover, several recent bipartisan reports have highlighted the damage done by the private securities litigation system to U.S. competitiveness in the global capital markets and, as a result, to the U.S. economy as a whole.

We have a regulatory structure filled with duplicative, inefficient, and, in some cases, contradictory guidance. Regulators struggle to keep up with the speed and technology changes of today's rapidly changing markets. While no business should be forced to read the minds of the regulators, it is particularly difficult for smaller public companies to deal with these issues. The system is not working.

What Can We Do?

The challenge is clear and the voices are growing. The Chamber's independent, bipartisan Commission on the Regulation of U.S. Capital Markets in the 21st Century and others, including Hal Scott from Harvard, Senator Schumer and Mayor Bloomberg and, most recently, the Financial Services Roundtable has echoed that the problems facing our competitiveness are real and action is needed. We should remain united in our goal to make the U.S. capital markets the most fair, efficient, transparent, and attractive in the world.

That is why the Chamber formed the Center for Capital Markets Competitiveness in March 2007. The Center was established to advance legislative, regulatory, and legal initiatives designed to strengthen the competitiveness of U.S. capital markets.

Granting a further delay for small business in complying with Section 404 would be a good step towards addressing these larger issues. But we cannot stop there. We need broad litigation and regulatory reform to retain our global capital markets leadership.

Conclusion

Chairwoman Velázquez, Ranking Member Chabot, and members of the committee, thank you for the opportunity to discuss these serious issues. The Chamber stands ready to work with you and others to improve the implementation of SOX 404—and we congratulate you for taking this important step by holding today's hearing. We also applaud Chairman Cox and Chairman Olson for the work they have done.

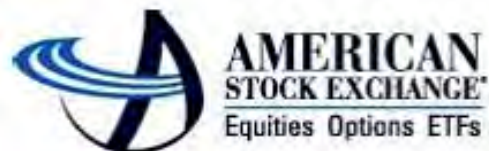
In summary, we believe that we will only know if the efforts of the SEC and PCAOB have been successful until after we see how they are implemented. Therefore, we are again calling for a further delay of one full-year for smaller public companies before they must comply with Section 404. Finally, we urge Congress, the SEC, and other regulators to work together to address the additional critical issues that are making it increasingly difficult for leaders of smaller American companies to access the public capital markets to grow their businesses and create jobs.

Thank you again for the opportunity to be here today. We stand ready to take action on behalf of the business community to provide viable solutions that benefit business, workers, shareholders and our economy.

U.S. Chamber of Commerce
Center for Capital Markets Competitiveness
Cost of SOX 404 Survey
November 8, 2007

Prepared by:

U.S. Chamber of Commerce
Research and Analysis Center
1615 H Street, NW
Washington, DC 20062
202-463-5500



CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

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Introduction

In October 2007, the U.S. Chamber's Center for Capital Markets Competitiveness (CCMC) with the assistance of the U.S. Chamber's Research and Analysis Center (RAC) conducted an on-line survey to compile data on the projected cost of Sarbanes-Oxley (SOX) Section 404 and its impact on small businesses. Section 404 requires management and the external auditor to report on the adequacy of the company's internal control over financial reporting. This report provides an overview of those survey results.

The Methodology

An electronic survey was developed and emailed to approximately 5000 contacts provided by the CCMC and other organizations including, American Banker's Association, American Stock Exchange, and the Institute of Management Accountants. The survey was launched on October 10, 2007 and remained open until October 26, 2007, with one reminder sent on October 15, 2007. During that time, 177 people completed the survey. Of the 5000 potential participants, 16 addresses were invalid (14 bounced, 2 opted out), leaving a universe of 4984 potential participants. 3.6% of this group completed the questionnaire during the response period.¹

The online survey was emailed to the CCMC small business contacts that could potentially be affected by the implementation of SOX Section 404.

The survey employed Likert scales for some of the questions. The Likert scale is the most commonly used scale in survey research, as it allows respondents to easily rate items. For example, respondents in this survey were asked to rate to which extent (great, moderate, very little) companies would be able to detect and prevent material fraud by complying with SOX 404.

Each response was added to calculate a single score for each program area. Using the Likert scale allows the CCMC to easily understand the relative importance of each issue. Additionally, questions were a mix of multiple-choice or self-responding segments, in which respondents could write their own comments/opinions on the subject matter.

In addition, respondents were not required to answer the questions, which dispersed possible "factor fusion." Factor fusion restricts perceptions and desires of survey respondents into a smaller space. Since factor fusion was not present in this survey, overall results are more accurate.

Survey responses were anonymous and completion of the survey was voluntary. No incentive was offered. Some total percentages do not equal 100% due to rounding.

Based on the response rate and varied demographics of participants, the Research and Analysis Center at the U.S. Chamber of Commerce is confident that the research results presented within this report can be considered to be generally representative of thoughts, opinions and perceptions of the small business universe.

¹ The margin of error is $\pm 3\%$, with a confidence level of 95%. The results can be considered to be statistically significant due to the response rate (3.6%) and number of viable cross tabulations.

The Respondents

- The majority of the respondents (89.8%) are public companies.
- Respondents primarily work in the financial services industry (24.7%), followed by the manufacturing industry (15.7%). Over one-third of respondents (36.1%) report working in an industry not listed, and included in that group are 11.4% of total respondents indicating their primary industry is mining and/or mineral exploration.
- Exactly 50% of the respondents describe their company's public float as \$75 million or less, and nearly three-quarters (74.1%) describe it as less than \$200 million.

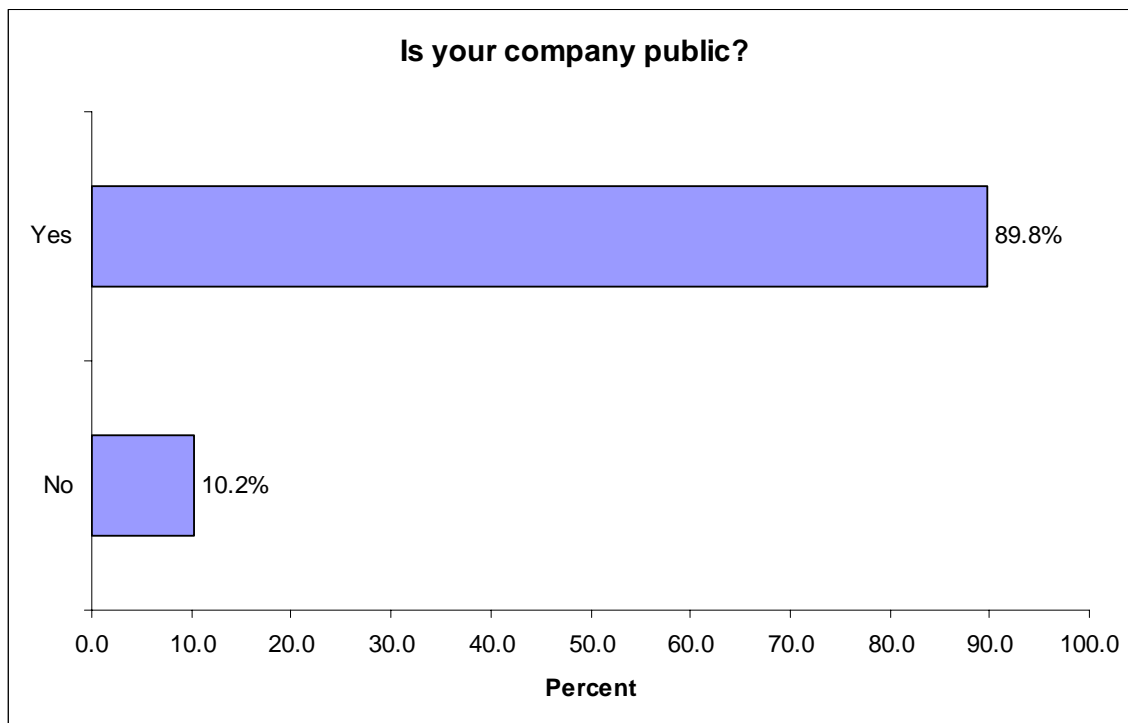
Key Highlights

A total of 177 surveys were received. The findings as stated in this document are only indicators of the opinions of the respondents. Please note that percentages throughout this document may not total 100%, as some respondents did not answer all questions and/or due to rounding.

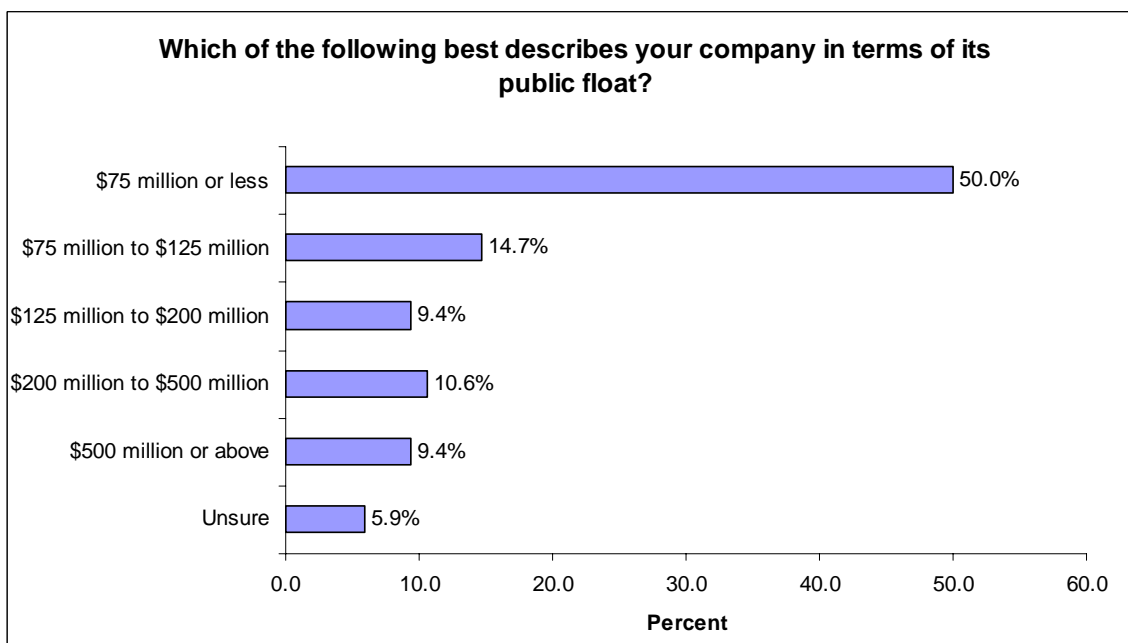
- Nearly two thirds (64%) of respondents expect an increase in costs in 2008 and 2009 due to compliance with 404(a) and 404(b).
- Almost half (47%) of the respondents expecting an increase in costs due to compliance are anticipating those costs to exceed \$100,000.
- Approximately nine out of ten respondents (89%) expect costs will "greatly exceed" or "moderately exceed" the benefits of SOX 404 compliance.
- Fifty-nine percent of respondents when asked "to what extent do you expect compliance with SOX 404 will allow your company and your company's auditors to detect and prevent material fraud?" indicated "very little at all".
- The majority of respondents (84%) have engaged an auditor as they prepare to comply with SOX 404(a) requirements to be filed in 2008 and two-thirds (66%) have engaged an auditor to comply with SOX 404(b) requirements to be filed in 2009.
- Over half of respondents, with public float less than 75 million (52%) expect internal and external costs to implement SOX 404(a) this year to exceed \$200,000 while forty-four percent of respondents expect implementation costs of 404(b) to also exceed \$200,000.
- The majority of respondents (79%) feel a delay in the compliance deadline for SOX 404(a) and 404(b) would be helpful to their company.

Findings

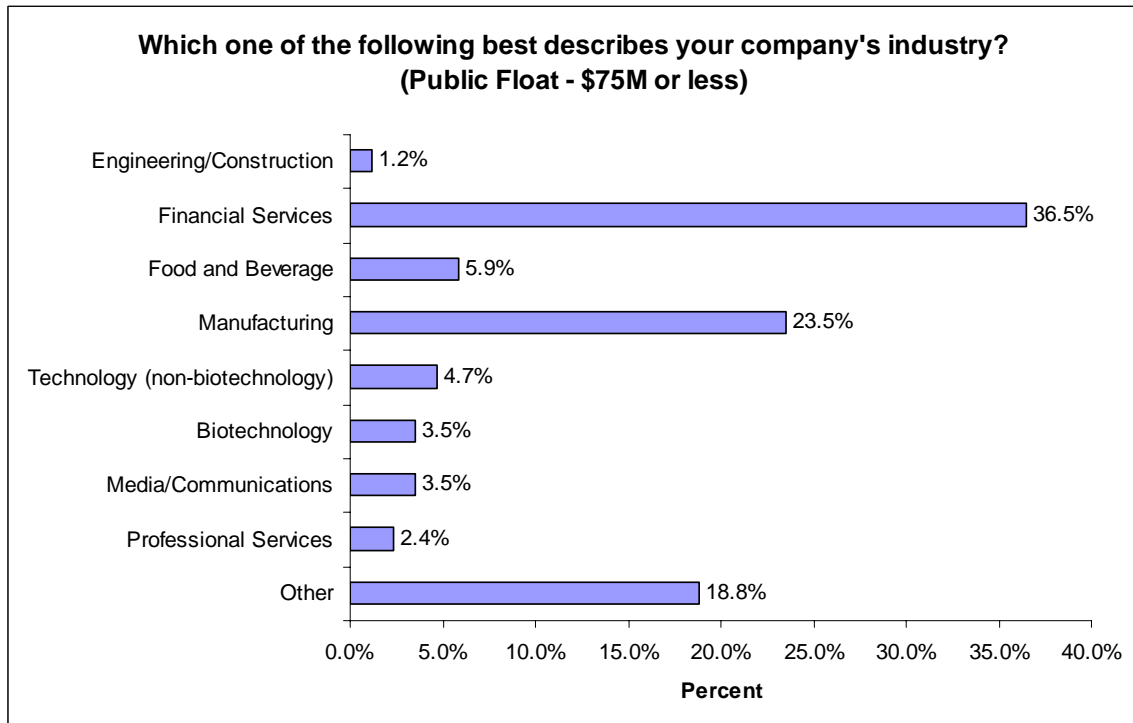
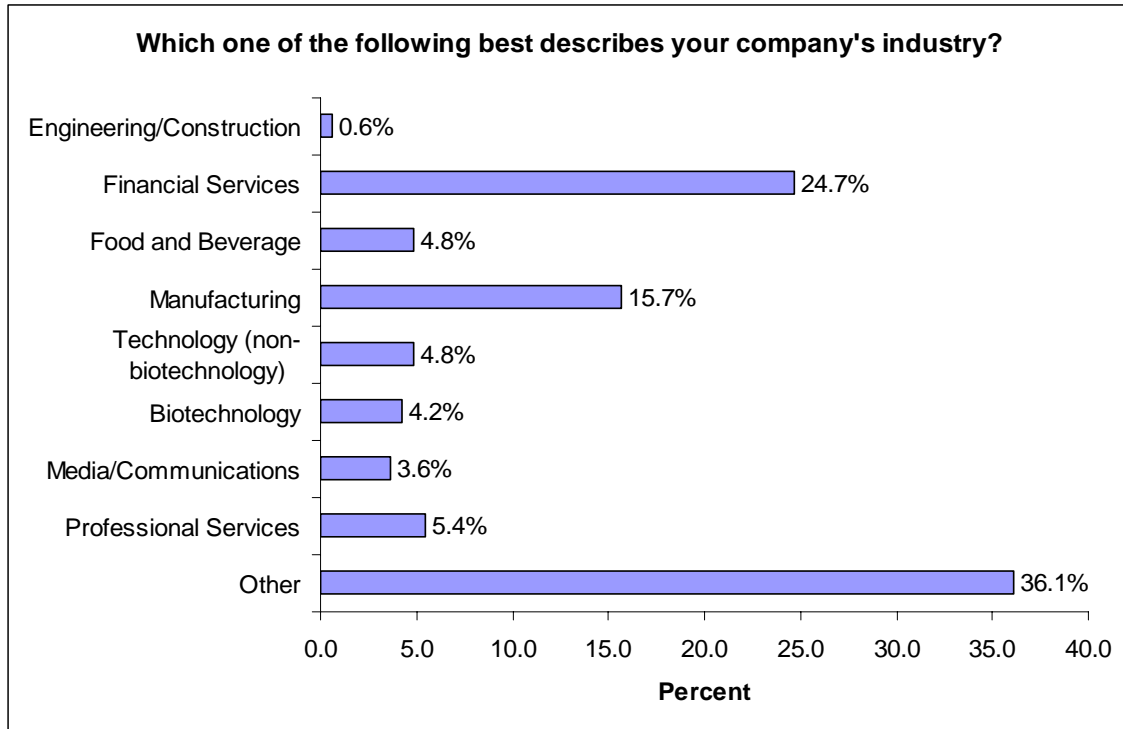
Type of Company



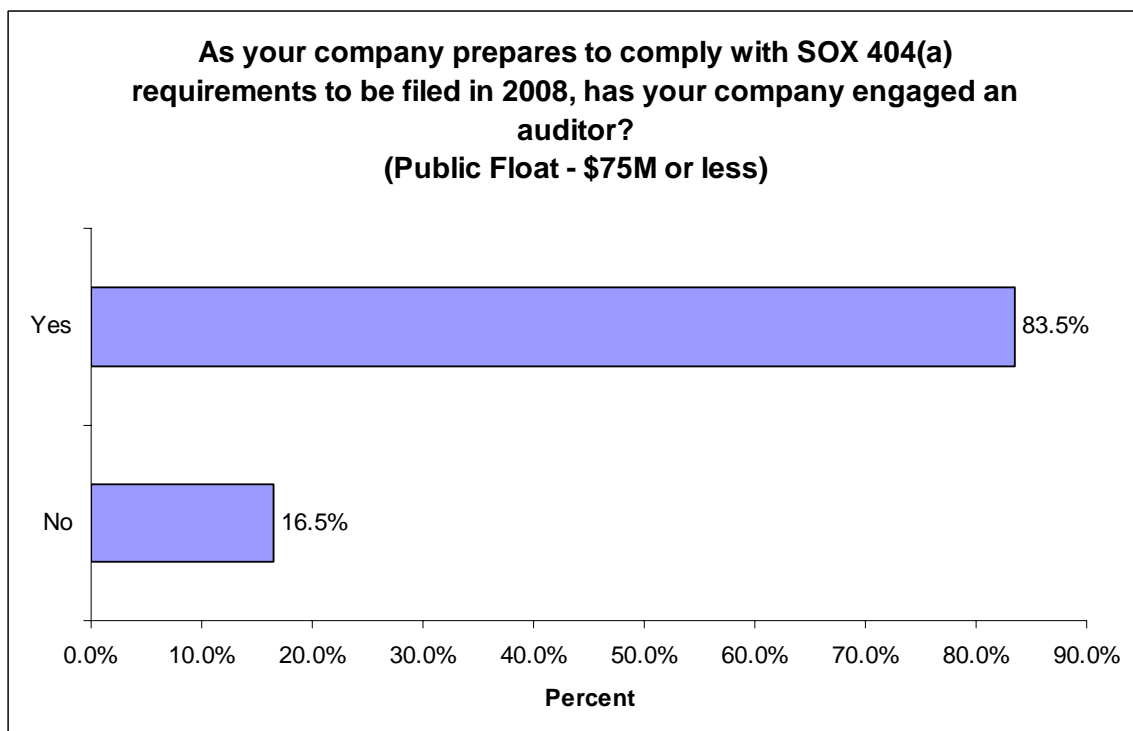
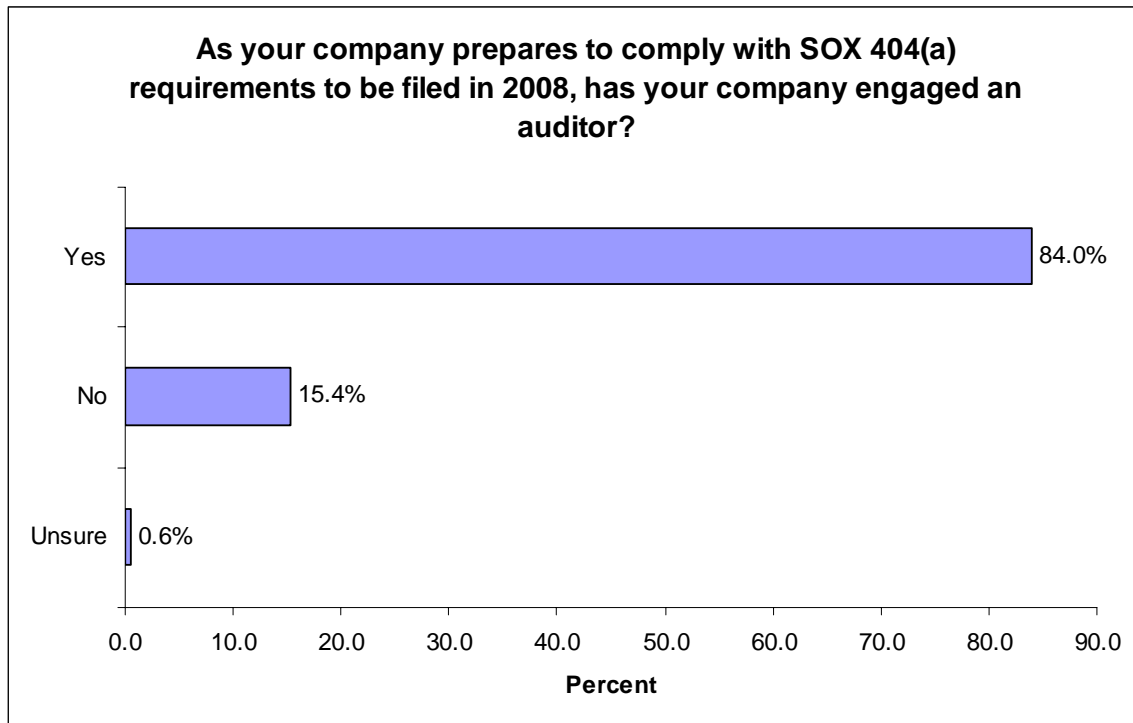
Public Float



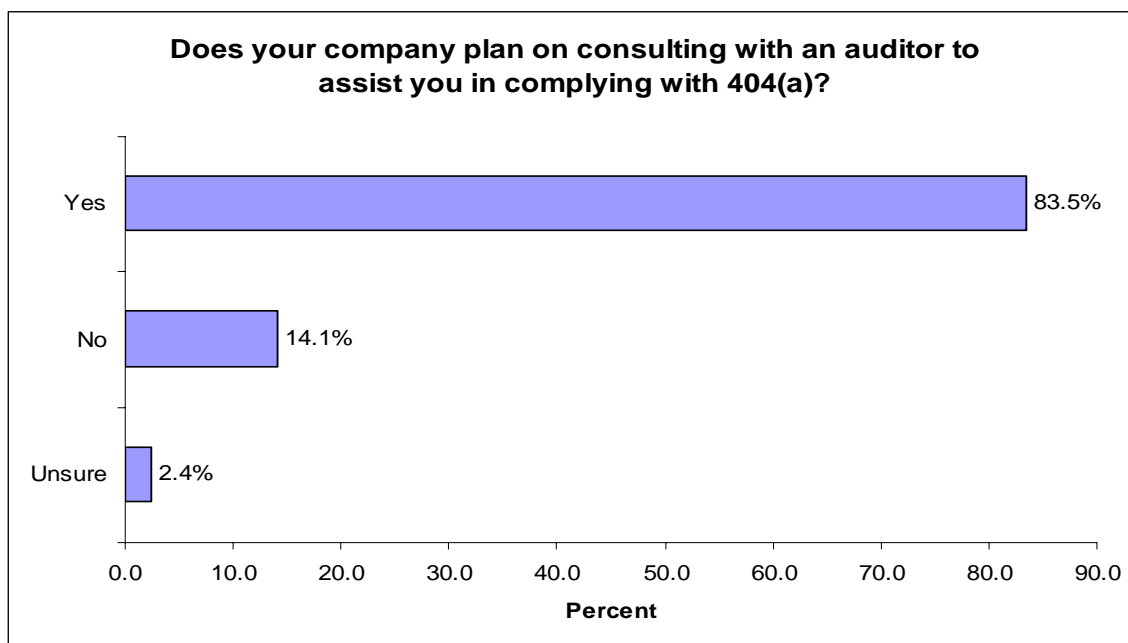
Industry



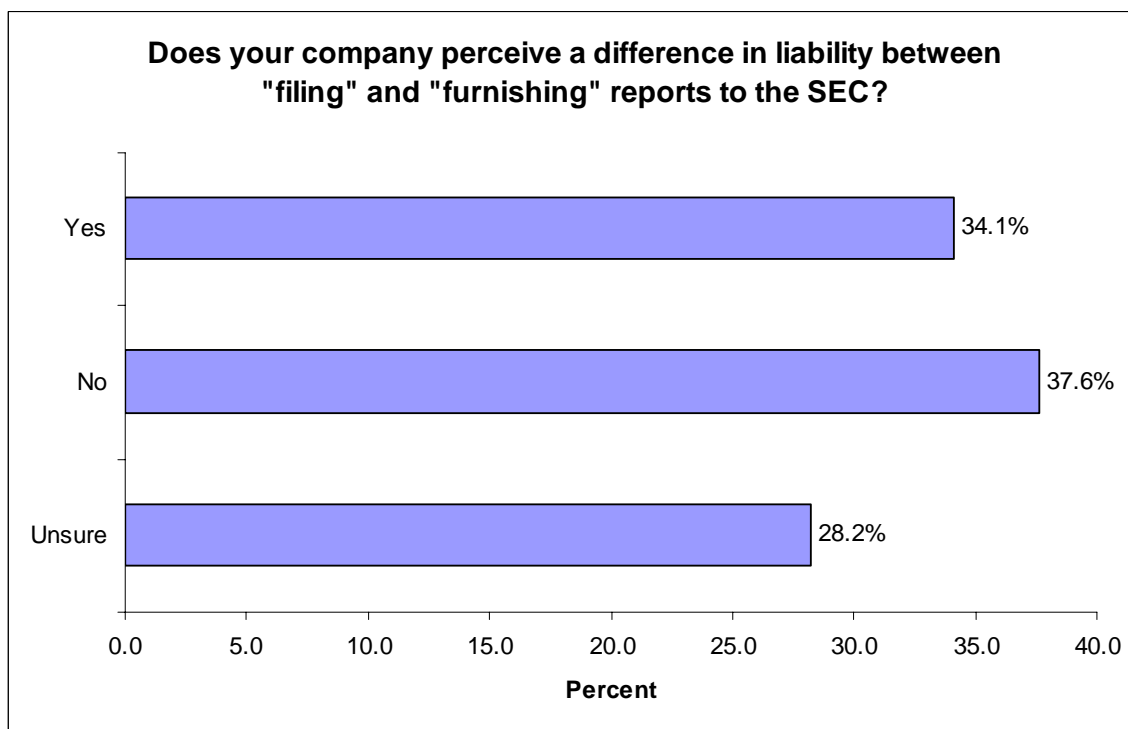
Engagement of an auditor in 2008



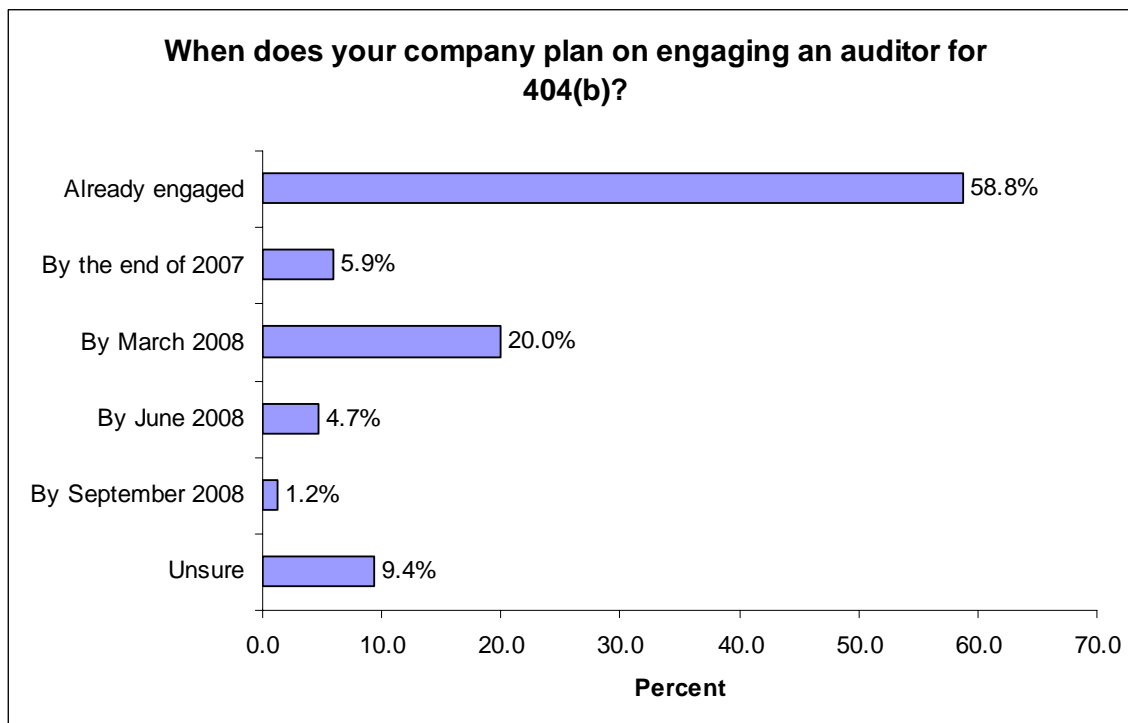
**Consultation with an auditor regarding 404(a)
(Public Float - \$75M or less)**



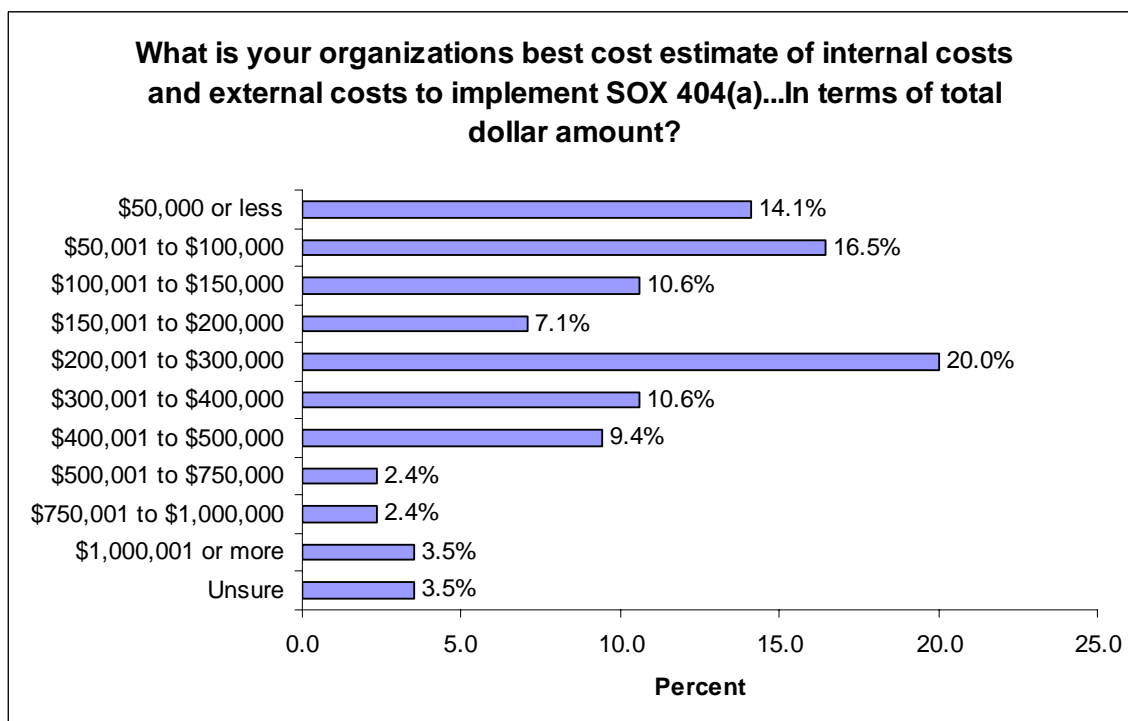
**Difference in liability between "filing" and "furnishing" SEC reports
(Public Float - \$75M or less)**



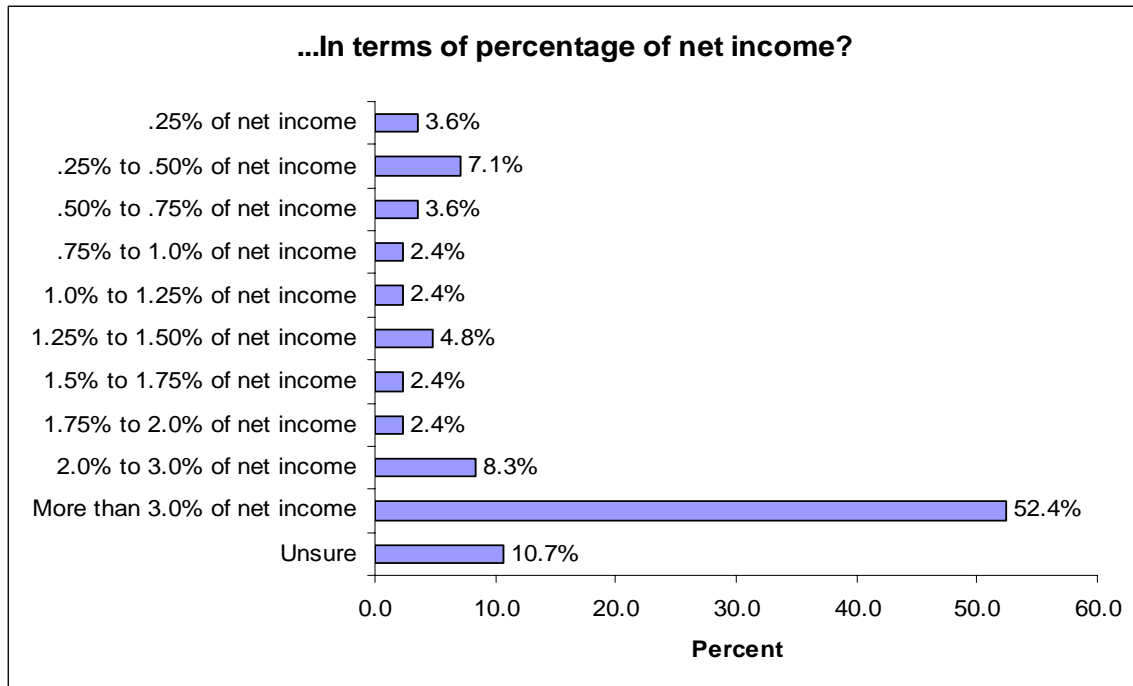
**Timing of engaging an auditor for 404(b)
(Public Float - \$75M or less)**



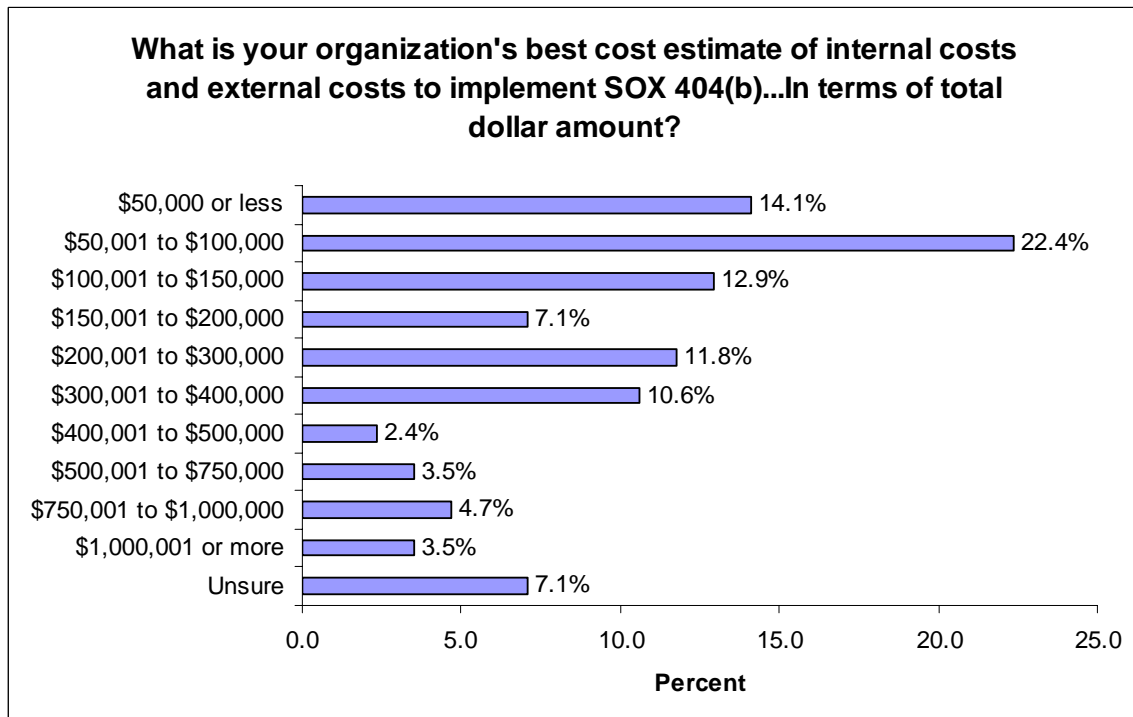
**Implementation of SOX 404(a) – Dollar Amount
(Public Float - \$75M or less)**



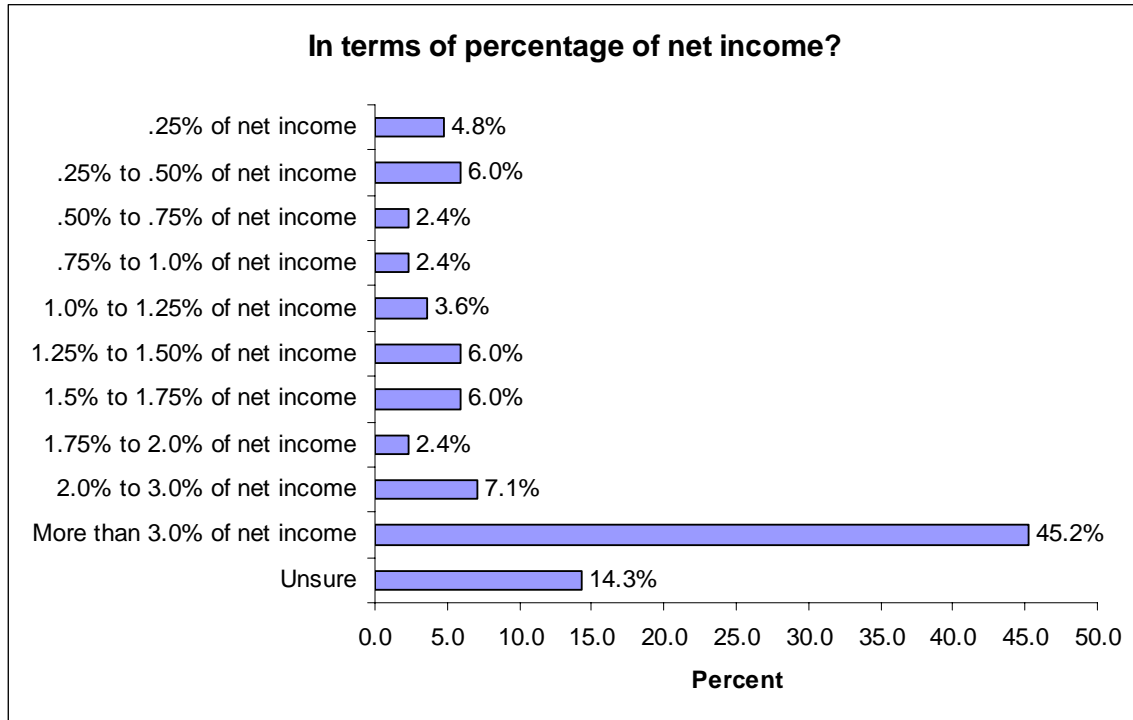
Implementation of SOX 404(a) – Percentage of Net Income (Public Float - \$75M or less)



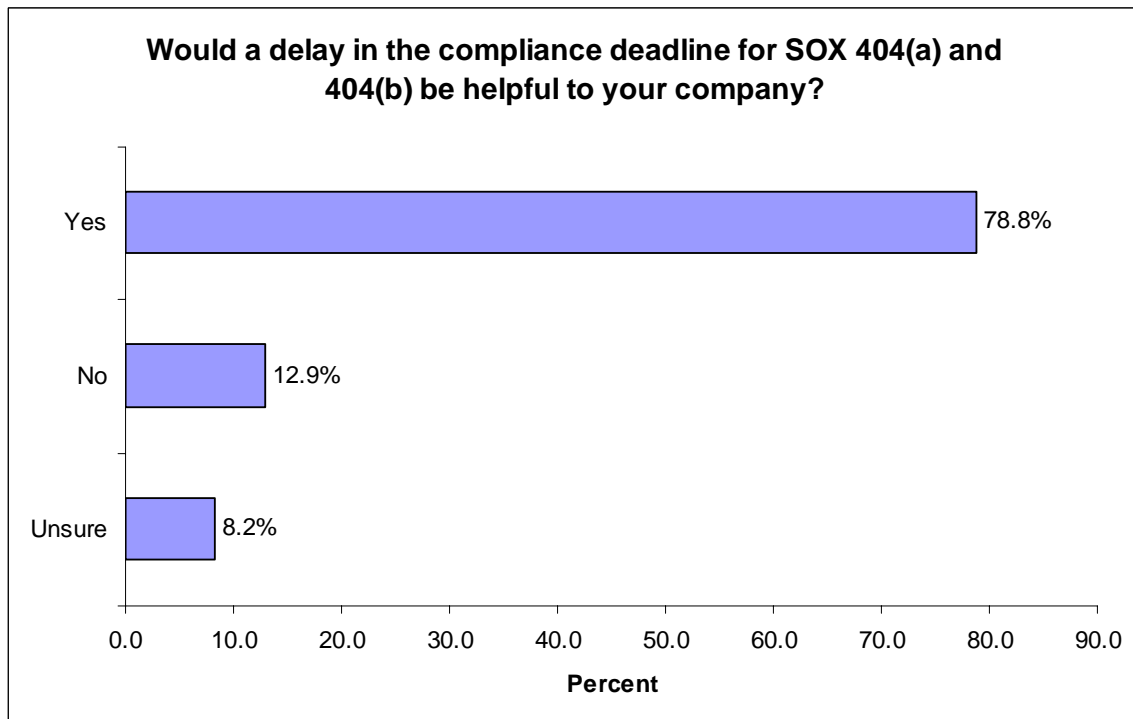
Implementation of SOX 404(b) – Dollar Amount (Public Float - \$75M or less)



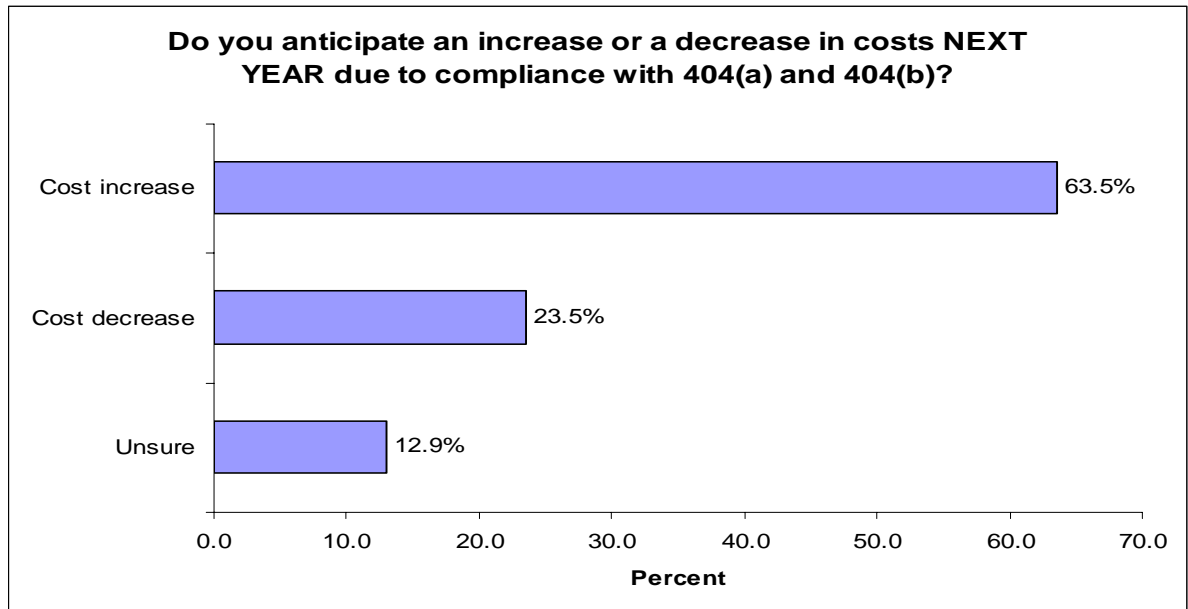
Implementation of SOX 404(b) – Percentage of Net Income (Public Float - \$75M or less)



Delay in the compliance deadline (Public Float - \$75M or less)



Fluctuation of costs next year (Public Float - \$75M or less)



Cross Tabulation 1

“Do you anticipate an increase or a decrease in costs NEXT YEAR due to compliance with 404(a) and 404(b)?”

“Based on your answer to the previous question, please quantify the increase/decrease your organization expects in terms of dollar amount.”

	\$50,000 or less	\$50,001 to \$100,000	\$100,001 to \$150,000	\$150,001 to \$200,000	\$200,000 to \$300,000	\$300,001 to \$400,000	\$400,001 to \$500,000	\$500,001 to \$750,000
Cost Increase	18.9%	15.4%	9.5%	8.3%	4.7%	3.5%	1.2%	2.4%
Cost Decrease	8.1%	5.8%	3.5%	2.3%	2.3%	0%	1.2%	0%

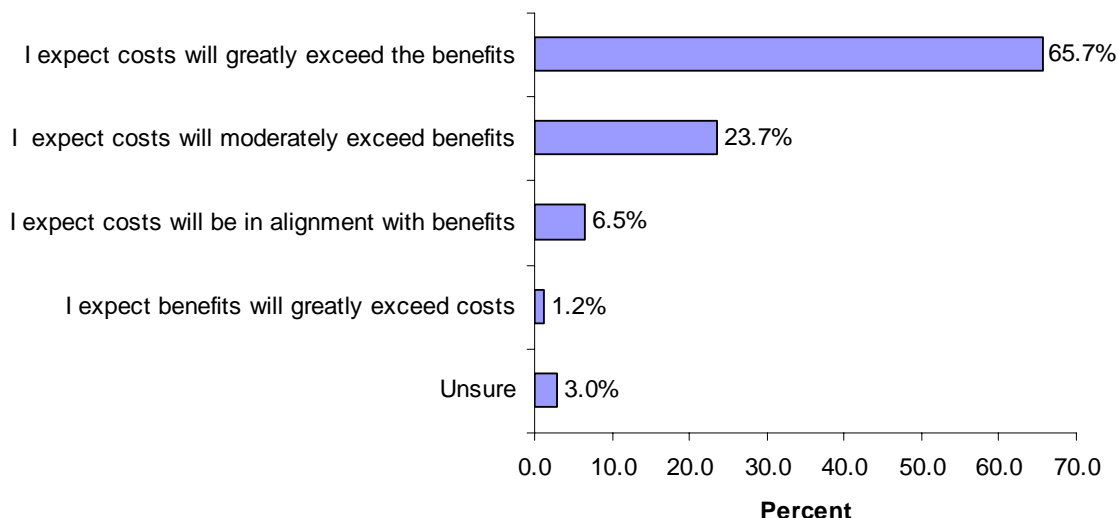
Cross Tabulation 2

“Please quantify the increase/decrease your organization expects in terms of net income.”

	.25% of net income	.25% to .50%	.50% to .75%	.75% to 1.0%	1.0% to 1.25%	1.25% to 1.50%	1.50% to 1.75%	1.75% to 2.0%	2.0% to 3.0%	More than 3.0%
Cost Increase	8.4%	1.2%	3.6%	3.6%	8.4%	1.2%	3.6%	.0%	6%	27.8%
Cost Decrease	4.6%	.0%	1.2%	2.3%	2.3%	.0%	1.2%	2.3%	1.2%	8.1%

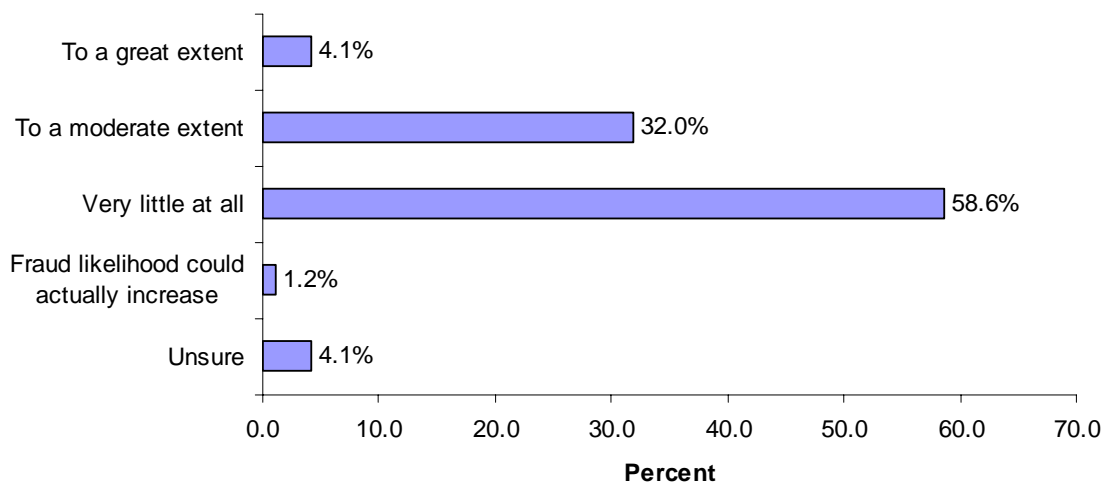
Costs vs. Benefits
(Public Float - \$75M or less)

Looking ahead to December 2008, do you expect that the costs associated with your company's compliance with section 404 will be in alignment with the benefits of SOX 404 compliance?



Degree of detecting and preventing material fraud
(Public Float - \$75M or less)

Looking ahead to December 2008, to what extent do you expect compliance with SOX 404 will allow your company and your company's outside auditors to detect and prevent material fraud?



Demographics

This survey includes 177 respondents, consisting of 90% from public companies with 50% public float of less than \$75 million.

Public Company

Yes	90%
No	10%

Public Float

\$75 million or less	50%
\$75 million to \$125 million	25%
\$125 million to \$200 million	9%
\$200 million to \$500 million	11%
\$500 million or above	9%
Unsure	6%

Respondents represent varying industries and company types. One in four respondents work in the financial services industry (25%), while the second largest industry grouping is manufacturing at 16%. "Mining and Mineral Exploration" was not listed as a specific category, but 11% of the respondents indicated this as the industry in which they work.

Type of Industry

Financial Services	25%
Manufacturing	16%
Mining and Mineral Exploration	11%
Food and Beverage	5%
Technology (non-biotechnology)	5%
Professional Services	5%
Media/Communications	4%
Biotechnology	4%
Engineering/Construction	1%
Other	25%

Comments

The respondents were asked to “provide additional information regarding their company’s experience with SOX Section 404 compliance, including their asset size information.” Below please find the respondent’s answers (unedited).

- SOX was well-intentioned but its implementation was misplaced and impractical. The costs have far outstripped the benefits. More importantly, SOX necessitates a level of bureaucracy that is severely hampering small entrepreneurial companies that I fear will stifle innovation and competition. SOX is a revenue generator for the accounting firms but adds little value to the business environment resulting in inefficiencies. To give you an example, a small company might spend \$300K to hire an audit firm to help them implement or maintain SOX compliance for one reporting period, or alternatively that same company could spend that \$300K on a phase 1 study that might prove the viability of a particular drug candidate that is critical to filling an unmet need, as the CEO of that fictional company where would you rather spend your shareholders investment? If one were to evaluate SOX on a ROI basis I suspect it would rarely be positive.
- We are finding that we already have many controls in place; we just lack physical proof or documentation to show someone we did those procedures. Thus SOX is nothing more than overkill and a busy-work maker that kills office productivity.
- Multiple shareholders have asked if it is possible to opt out of SOX compliance as it is a waste of corporate resources.
- We are currently a SOX compliant accelerated filer. It does not appear that PCAOB No. 5 will result in a material decrease in our SOX compliance costs.
- \$925MM in assets. We have been SOX 404 compliant since its inception and have found it to be very costly with minimal benefit to detect fraud. It has provided some focus on creation or improvement of internal procedures; however, it is written without clarification of control processes that are material (ie: Lending, IT, etc.).
- We are a 2.5 billion dollar community banking organization and have been reporting under 404 for 4 years. Our external audit costs have doubled under 404 and our internal costs have exceeded that. Our external auditing firm (Big 4) has not reduced fees as expected with the 2007 SEC and PCAOB reforms.
- While evaluating controls for SOX is a good exercise, financial institutions are already scrutinized to a great degree by external auditors and state and federal examiners. This seems to be a redundant exercise that has not shown a great amount of benefit to the operations. Controls have always been key in the banking industry.
- The first year was very time consuming and expensive as we are now in year 2 and we have found the time and cost have decrease and expect this trend to continue.
- Cure is worse than the disease. Enron broke existing laws. They are the exception not the rule. Small cap companies are leaving the US public markets in droves. This is not good for the US economy.

- We find some procedures to be very helpful and beneficial and others to be unnecessary in that the return on doing them is difficult at best to quantify, if at all.
- Due to time constraints we engaged an outside firm to assist with SOX internal control documentation and testing. The work was performed by junior staff. Educating our consultants about our business took time away from actually managing the business. I do not believe that a binder full of flow charts and narratives is a meaningful addition to intelligent management nor is it a panacea for poor management.
- I thought that the laws and rules regarding the audit of the company were sufficient before SOX; all the SOX act did was combine the already existing rules and create an additional oversight body.
- After three years, now pretty much in order. Would like to see SOX self-assessed and complied with, without need for external audit opinion.
- There is a significant cost, and for a company of our size, it has consumed a significant amount of time resources as well.
- I still believe the audit standards are way too out of line to reality and that minor issues are reviewed at the audit level as if they were major mistakes. SOX effort regarding controls will continue to be a big debate as well mitigation efforts of those controls. We need more guidance toward dollar amounts and transaction amounts that would be relevant, not just interesting.
- We are an accelerated filer. So, we have already experienced the 404 compliance process. It is costly, and does not seem to provide more assurance about the integrity of the financial statements than would be achieved without the 404 requirements. We have been undergoing a significant growth phase within our company for the past several years, though; and being required to comply with 404 has enforced a level of discipline we might very well have neglected otherwise.
- Costs significantly outweigh benefits for our organization. Auditors have lost sight of the big picture and focused too much on the minutia.
- The objectives of SOX could be accomplished through the traditional internal audit function as opposed to having a separate compliance effort. Also, the value that the external audit provides in providing their opinion on the internal controls over financial reporting is minimal.
- We are a small cap multinational company with 9 locations all of which require documentation of controls. The problem is depending who you ask and when you ask you get a variety of answers. Everyone thinks they know what the auditors want and the auditors don't even know what they want. What a waste of time and money.
- Terrible waste of costs. We are a very simple company to get our hands around and nothing bad that would be material could be done without being noticed by many internal and external people. A few entity level controls could easily cover any material risk. Instead we will be paying a sum equal to our audit fee (approximately the costs of 4 engineers) to test key controls at the detail level.
- The additional time required of senior and mid-level management, as well as the board of directors, significantly reduces time available toward more productive, growth oriented

efforts and initiatives. As well, the compliance efforts have negatively impacted our relationship with our auditors, and have caused us to hire other firms to assist with accounting and control-related matters.

- AS5 should help. However, the top down implementation approach for implementing SOX remains very expensive for a small company. Most non-financial executives believe SOX is the full employment act for CPA's.
- It is exorbitant cost that outweighs benefits, does little for market reaction, and restricts certain investment and growth.
- We are in our third year of compliance. In year one, our audit cost doubled. It has not diminished since.
- It is very difficult to articulate to line managers and supervisors (those outside of the accounting profession) the concepts and definitions within the context of SOX.
- Asset size \$2.3 billion. We have been compliant since 2004. Our experience has been that the focus on SOX 404 is simply documentation of what most financial institutions have maintained as controls historically. The benefits, now that there is better guidance from the SEC (see August Reg. release) and the Independent Auditors (AS 5), far outweigh the costs. While initially cumbersome, our system now focuses on excellent Internal Controls over Financial Reporting. We do not even use "SOX" any longer. There are really two choices: Embrace the documentation as best practices or whine.
- Very small public company; with net losses; the SOX costs, with the amount of internal expertise required is unrealistic for our size and profitability.
- Our bank has an asset size of \$45 million. We will incur a direct external expense in 2007 of approximately \$75,000 to document and comply with 404a. While the purpose of SOX is well-intended to put in place reliant control structure, compliance for an institution of our size and structure has created extremely negative earnings consequences because there has been little to no consideration for asset size, human or dollar resources. Enhancing shareholder value is our main goal through safe, sound, effective and efficient controls and operations. Very little about SOX is efficient. Let's hope it will at least be somewhat effective.
- We are a \$138MM asset community bank. 404 did not add anything to our internal control system, but it does add significant cost. We are already audited (internal and external) and examined so much that this does not do much but require us to re-document everything in another format. Controls should be in place to enable you to run your business in a safe and sound manner, understanding the risks. Our philosophy is not to grow so fast that we outpace our infrastructure-- therefore we did not need 404 to document or test our controls. We do it all the time. This is a waste of time and money. Criminals get around controls anyway, so you are only punishing the people who normally comply anyway just because it is the right thing to do.

1. Can you clarify whether or not the SEC has developed a cost estimate associated with the implementation of its newly adopted revised rules and guidance for management under Section 404(a) by non-accelerated and accelerated filers?

a. If the SEC has developed an estimate, the Committee requests a copy of the estimate and an explanation of the methodology used to develop the estimate.

b. If the SEC has not developed a cost estimate for the implementation of the newly adopted revised rules and guidance for management, the Committee requests an explanation of why a cost estimate was not developed.

The Commission analyzed the costs and benefits of its recently adopted revised rules. A copy of that analysis, which is included as part of the adopting release for the newly revised rules, is enclosed and explains the methodology.

As you know, compliance with the Commission's new management guidance is entirely voluntary. The guidance does not impose any new obligations on any reporting company. As a result, we have every reason to expect that companies and their management will choose to use the guidance only if they determine that the benefits will exceed the costs and that use of the guidance will reduce their overall compliance burden.

2. Does the SEC expect that non-accelerated filers will not hire external auditors in 2007 to assist them in meeting the management requirements of SOX 404(a) for financial statements filed in 2008?

We believe that management may satisfy the assessment obligation without assistance from their external auditor. The fourth and most recent extension provided for non-accelerated filers, which was approved by the Commission on December 15, 2006, bifurcated management's assessment and the auditor attestation requirements. As a result, non-accelerated filers are only required to meet the management assessment requirement of Section 404(a) in annual reports to be filed in 2008 – not the auditor attestation requirement of Section 404(b).

To facilitate this result and to reduce any second-guessing of management, the SEC's rules provide that the management report during the first year of Section 404(a) compliance is deemed to be "furnished" rather than "filed." This means that the management report will not be the basis for liability under Section 11 of the Securities Act or Section 18 of the Exchange Act (unless the issuer specifically chooses to include the report in a filed report, proxy statement, or registration statement).

In the event that management wishes to consider how their assessment in 2008 might impact the auditor attestation required for subsequent years, there is, of course, no restriction on their ability to seek feedback from their auditor. In this, the subject of internal controls is not qualitatively different from any other area in which the company may desire the auditor's perspective. We have consistently encouraged management to have an open dialogue with their auditor. But the extent to which management has a

dialogue with their auditor in the first year is entirely at their discretion, since the SEC has deferred the audit requirement until the second year.

3. What information does the SEC have about when (under the existing compliance timeline) in the process of becoming SOX 404 compliant a non-accelerated filer will hire outside auditors to conduct a SOX 404 audit?

Under the current timeline, non-accelerated filers will be required to provide an auditor's attestation to management's assessment of internal controls over financial reporting for fiscal years that end on or after December 15, 2008. This attestation is to be provided as part of an integrated audit of the financial statements. Since companies generally engage auditors to perform the subsequent year's audit shortly after they file their annual reports, we would expect that non-accelerated filers that are calendar year companies would engage their auditors in the first half of 2008, with the majority of the work being performed later in 2008 and early 2009.

4. Assuming that the SEC maintains the existing SOX 404(a) compliance timetable for non-accelerated filers – compliance for 2007 results with respect to financial statements filed in 2008 – does the SEC have a plan to collect data on costs that non-accelerated filers bear as a result of SOX 404(a) implementation?

If the SEC has a plan to collect data on SOX 404(a) compliance costs borne by non-accelerated filers, the Committee requests that the SEC's response to this question be as specific as possible and should reference:

- The dates by which the SEC's data collection will begin;
- The specific resources within the Commission that will be directed to collect and analyze the data;
- The approach or methodology the SEC will use to collect and analyze the data; and
- An indication of what standard the data will be measured against to determine if the costs constitute a "disproportionate" burden for small companies.

Yes. The SEC is currently planning to collect data on costs that non-accelerated filers bear as a result of Section 404(a) implementation. The data collection will begin after the non-accelerated filers first file Section 404(a) management reports. The Commission's Office of Economic Analysis will collect and analyze the data, with assistance from the Office of Small Business Policy in the Division of Corporation Finance and the Commission's Office of the Chief Accountant. The data will be compared with data on costs incurred by accelerated filers and large accelerated filers.

5. During the public comment period associated with AS-5, does the SEC intend to develop a cost estimate for AS-5? If so, will the SEC make public the cost estimate for public comment before it votes on final approval of AS-5?

- a. If the SEC intends to develop a cost estimate of AS-5, the Committee requests a copy of the estimate and an explanation of the methodology used to develop the estimate.**
- b. If the SEC does not intend to develop a cost estimate for the implementation of the proposed new guidance for management, the Committee requests an explanation of why a cost estimate was not developed.**

During consideration of the new auditing standard, the Commission sought comment on whether people expected AS-5 to reduce audit costs, particularly for smaller companies. The SEC also plans to conduct economic analysis using real-world information from the implementation of AS-5 to evaluate whether the costs are in fact reduced in line with the Commission's expectations. The data collection will begin when issuers first file their annual reports using AS-5. The Commission's Office of Economic Analysis will collect and analyze the data, with assistance from the Office of Small Business Policy in the Division of Corporation Finance and the Commission's Office of the Chief Accountant.

6. What is the SEC's plan for collecting SOX 404 compliance cost data from accelerated filers who implement the new revised rules and guidance for management under Section 404(a) and who implement AS-5 under 404(b), for financial statements filed in 2008?

If the SEC plans to collect data on SOX 404 compliance costs borne by accelerated filers, the Committee requests that the SEC's response to this question be as specific as possible and should reference:

- The dates by which the SEC's data collection will begin;**
- The specific resources within the Commission that will be directed to collect and analyze the data;**
- The approach or methodology the SEC will use to collect and analyze the data; and**
- An indication of what the data will be measured against to determine that the new standards have not only lowered audit efficiency but also lowered compliance costs (e.g., existing SOX 404 compliance cost data for accelerated filers).**

As noted in response to questions 4 and 5, the SEC is currently planning to collect data on costs that accelerated filers bear as a result of Section 404 implementation. The Commission's Office of Economic Analysis plans to collect and analyze the data, with assistance from the Office of Small Business Policy in the Division of Corporation Finance and the Commission's Office of the Chief Accountant. The data will be compared with compliance cost data available for periods prior to availability of the SEC guidance and revised AS-5. We expect the new standards to reduce audit costs.

7. In your testimony you indicated a willingness to reassess the compliance deadline associated with small company implementation of AS-5, if data were to show that the new standards are not having the intended effect. Assuming the presence of sufficient data, does the SEC plan to convene a meeting of the Commission to assess the SOX 404 compliance cost data?

- a. **If so, during what month in 2008 will that meeting take place so as to allow the SEC Commissioners to consider extending a delay?**
- b. **If not, what trigger will the SEC use to ensure that the Commission confirms that the data collected demonstrates that the proposed new standards have adequately addressed the Commission concerns about the disproportionately high costs of SOX 404 compliance to small companies?**

Yes, the Commission intends to assess SOX 404 compliance cost data and to closely monitor the implementation of our new rules, management guidance, and AS-5, although this assessment and monitoring will not necessarily take place at a Commission meeting. We would, however, schedule at least one and probably two open meetings of the Commission to consider a proposed and final rule extending the compliance deadline if it appears that further delay of the compliance deadline associated with smaller company implementation of AS-5 is warranted. While it would be premature at this point to predict whether the Commission might act, if the Commission should choose to act it would do so in time to complete final action by June 2008 (see response to question 3).

8. How will the SEC assess whether its new guidance and AS-5 have or have not lowered SOX 404 compliance costs? What measure will the Commission employ to determine whether non-accelerated filers should or should not be directed to implement AS-5 after December 15, 2008?

The SEC will assess the success of its new guidance and AS-5 in reducing Section 404 compliance costs based on cost data collected from filers and analyzed by the Office of Economic Analysis. The Commission will consider both qualitative and quantitative data in determining whether further delay is appropriate.

9. Has the SEC developed a detailed plan on how the SEC will educate small businesses on the implementation of the SEC guidance and AS 5?

- c. **If so, the Committee requests a copy of the plan.**
- d. **If not, by what date would this plan become available?**

Even as the interpretive guidance was written with smaller companies in mind, the Commission is also developing a brochure for smaller public companies to make it easy to understand and to apply. The PCAOB is also developing small-business educational materials to aid in implementing AS-5. Additionally, the SEC and the PCAOB will work to reach out to small businesses and their auditors on the implementation of the new SEC interpretive guidance and AS-5. Some of these outreach

activities are already planned or scheduled; other activities will be developed in the coming months.

The PCAOB will be holding forums on auditing in the small business environment. Participants in these forums include auditors from smaller registered public accounting firms and directors and financial executives of smaller public companies. SEC staff will participate in a number of these forums in order to provide education on the new guidance and rules. Six of these forums have either already occurred or are planned in 2007, including:

Fort Lauderdale – June 1
San Francisco – June 27/28
Atlanta – September 10/11
New York – October 22/23
Chicago – Date TBD
Washington, DC – Date TBD

Activities such as these will also provide the SEC and PCAOB with valuable feedback on smaller company issues with Section 404. The Commission is committed to helping smaller public companies begin to comply with the requirements set forth by Congress in Section 404.

10. Will the SEC provide the Committee with a copy of the SEC's analysis of the impact of the proposed guidance for management on small companies?

Yes. A copy of the Final Regulatory Flexibility Analysis, which is included as part of the adopting release for the newly revised rules, is enclosed.

11. Does the SEC believe that it has a legal obligation to estimate the costs and benefits to companies associated with the revisions of its rules under Section 404(a)? If not, why not?

Yes. The SEC is subject to a number of legal obligations relating to costs and benefits with which it complies when adopting Commission rules. Although this is not an exclusive list, among the specific requirements are:

- The Administrative Procedure Act requires the Commission to explain the basis and purpose for its rules.
- The Regulatory Flexibility Act requires the Commission to describe the impact on small entities of any rule required to be published for public comment.
- The Small Business Regulatory Enforcement Fairness Act requires the Commission to consider whether a rule's economic impact on small businesses will be "major."
- The Securities Exchange Act of 1934 requires the Commission to consider a rule's impact on competition.
- The Paperwork Reduction Act requires the Commission to estimate the burden of any collection of information.

- The National Securities Markets Improvement Act requires the Commission to consider whether a rule will promote competition, efficiency and capital formation, when it is required to consider or determine whether a rule is necessary or appropriate in the public interest.

12. Does the SEC have a legal obligation to estimate the costs and benefits to companies associated with the revisions of PCAOB's standards and guidance, in connection with the SEC's review and adoption of those changes? If not, why not?

Under Section 107(b) of the Sarbanes-Oxley Act of 2002 and Section 19(b) of the Securities Exchange Act of 1934, the SEC must approve a proposed auditing standard promulgated by the PCAOB if the SEC determines that the proposed standard is consistent with the Sarbanes-Oxley Act of 2002 and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors. By statute, the Commission makes such a determination with respect to PCAOB standards by issuing an order, not a rule. Therefore, the SEC does not prepare any of the regulatory analyses that accompany a rule, such as an analysis of the costs and benefits. Nonetheless, I have asked the SEC staff to conduct an economic analysis using real-world information to evaluate the costs and benefits of Section 404 implementation, including specifically the costs and benefits of the new AS-5.

13. At the hearing, an outstanding issue about the appropriate threshold for registration requirement was also raised. The SEC last updated the threshold for registration on May 1, 1996 when increasing the asset threshold of Rule 12g-1 from \$5 million to \$10 million. The Committee's understanding is that the SEC has stated that it would consider suggestions for revising the Rule's 500 shareholder threshold, originally set by the Congress in 1964. Can you clarify for the Committee whether the SEC has established a process and timeline by which the Commission will make a decision with respect to revising the 500 shareholder threshold?

I have directed the Commission staff to consider whether amendments are needed to the Commission's rules that relate to the shareholder threshold that triggers registration under Section 12(g) of the Securities Exchange Act of 1934. To aid in the analysis, on May 22, 2007, I asked the Commission's Office of Economic Analysis to undertake a review of the Section 12(g) registration standards to determine whether they continue to be the most appropriate means of accomplishing the objectives of Section 12(g). I have also asked the staff to complete its review and formulate a recommendation in an expeditious manner.